

Fundamentals of Multinational Finance, 3e (Moffett)

Chapter 5 The Foreign Exchange Market

5.1 Multiple Choice and True/False Questions

- 1) Which of the following is NOT true regarding the market for foreign exchange?
- A) The market provides the physical and institutional structure through which the money of one country is exchanged for another.
 - B) The rate of exchange is determined in the market.
 - C) Foreign exchange transactions are physically completed in the foreign exchange market.
 - D) All of the above are true.

Answer: D

Topic: Introduction to the Foreign Exchange Market

Skill: Recognition

- 2) A/An _____ is an agreement between a buyer and seller that a fixed amount of one currency will be delivered at a specified rate for some other currency.
- A) Eurodollar transaction
 - B) import/export exchange
 - C) foreign exchange transaction
 - D) interbank market transaction

Answer: C

Topic: Introduction to the Foreign Exchange Market

Skill: Recognition

- 3) While trading in foreign exchange takes place worldwide, the major currency trading centers are located in
- A) London, New York, and Tokyo.
 - B) New York, Zurich, and Bahrain.
 - C) Paris, Frankfurt, and London.
 - D) Los Angeles, New York, and London.

Answer: A

Topic: Introduction to the Foreign Exchange Market

Skill: Recognition

- 4) Because the market for foreign exchange is worldwide, the volume of foreign exchange currency transactions is level throughout the 24-hour day.

Answer: FALSE

Topic: Introduction to the Foreign Exchange Market

Skill: Recognition

- 5) Which of the following is NOT a motivation identified by the authors as a function of the foreign exchange market?
- A) The transfer of purchasing power between countries.
 - B) Obtaining or providing credit for international trade transactions.
 - C) Minimizing the risks of exchange rate changes.
 - D) All of the above were identified as functions of the foreign exchange market.

Answer: D

Topic: Foreign Exchange Market Functions

Skill: Recognition

6) The authors identify two tiers of foreign exchange markets:

- A) bank and nonbank foreign exchange.
- B) commercial and investment transactions.
- C) interbank and client markets.
- D) client and retail market.

Answer: C

Topic: Foreign Exchange Market Tiers

Skill: Recognition

7) The foreign exchange market is NOT efficient because

- A) market participants do not compete with one another due to the fact that exchange takes place around the world and not in a single centralized location.
- B) dealers have ask prices that are higher than bid prices.
- C) central governments dominate the foreign exchange market and everybody knows that by definition, central governments are inefficient.
- D) none of the reasons listed are accurate because the foreign exchange market is efficient.

Answer: D

Topic: Foreign Exchange Market Efficiency

Skill: Conceptual

8) Dealers in foreign exchange departments at large international banks act as market makers and maintain inventories of the securities in which they specialize.

Answer: TRUE

Topic: Foreign Exchange Market Dealers and Brokers

Skill: Recognition

9) Currency trading lacks profitability for large commercial and investment banks but is maintained as a service for corporate and institutional customers.

Answer: FALSE

Topic: Foreign Exchange Market Profitability

Skill: Recognition

10) It is characteristic of foreign exchange dealers to

- A) bring buyers and sellers of currencies together but never to buy and hold an inventory of currency for resale.
- B) act as market makers, willing to buy and sell the currencies in which they specialize.
- C) trade only with clients in the retail market and never operate in the wholesale market for foreign exchange.
- D) All of the above are characteristics of foreign exchange dealers.

Answer: B

Topic: Foreign Exchange Market Dealers

Skill: Recognition

11) Which of the following may be participants in the foreign exchange markets?

- A) bank and nonbank foreign exchange dealers
- B) central banks and treasuries
- C) speculators and arbitragers
- D) All of the above.

Answer: D

Topic: Foreign Exchange (FX) Market Participants

Skill: Recognition

12) _____ seek to profit from trading in the market itself rather than having the foreign exchange transaction being incidental to the execution of a commercial or investment transaction.

- A) Speculators and arbitragers
- B) Foreign exchange brokers
- C) Central banks
- D) Treasuries

Answer: A

Topic: Foreign Exchange (FX) Market Participants

Skill: Recognition

13) In the foreign exchange market, _____ seek all of their profit from exchange rate changes while _____ seek to profit from simultaneous exchange rate differences in different markets.

- A) wholesalers; retailers
- B) central banks; treasuries
- C) speculators; arbitragers
- D) dealers; brokers

Answer: C

Topic: Foreign Exchange (FX) Market Participants

Skill: Recognition

14) Foreign exchange _____ earn a profit by a bid-ask spread on currencies they purchase and sell. Foreign exchange _____, on the other hand, earn a profit by bringing together buyers and sellers of foreign currencies and earning a commission on each sale and purchase.

- A) central banks; treasuries
- B) dealers; brokers
- C) brokers; dealers
- D) speculators; arbitragers

Answer: B

Topic: Foreign Exchange (FX) Market Participants

Skill: Recognition

15) The primary motive of foreign exchange activities by most central banks is profit.

Answer: FALSE

Topic: Foreign Exchange (FX) Market Participants

Skill: Recognition

16) Dealers sometimes use brokers in the foreign exchange market because the dealers desire

- A) speed.
- B) accuracy.
- C) to remain anonymous.
- D) all of the above.

Answer: D

Topic: Foreign Exchange (FX) Market Participants

Skill: Recognition

17) Daily trading volume in the foreign exchange market was about _____ per _____ in 2007.

- A) \$3,200 billion; month
- B) \$1,000 billion; month
- C) \$3,200 billion; day
- D) \$1,000 billion; day

Answer: C

Topic: FX Trading Volume

Skill: Recognition

18) Daily trading volume of foreign exchange had actually decreased in 2004 from the levels reported in 2001.

Answer: FALSE

Topic: FX Trading Volume

Skill: Recognition

19) _____ are NOT one of the three categories reported for foreign exchange.

- A) Spot transactions
- B) Swap transactions
- C) Strip transactions
- D) Futures transactions

Answer: C

Topic: FX Trading Volume

Skill: Recognition

20) Foreign exchange swaps were larger in 1998 than in 2001. The Bank for International Settlements attributes this to

- A) the introduction of the euro.
- B) growing electronic brokering in the spot interbank market.
- C) consolidation in general.
- D) all of the above.

Answer: D

Topic: FX Trading Volume

Skill: Recognition

21) The greatest amount of foreign exchange trading takes place in the following three cities:

- A) New York, London, and Tokyo.
- B) New York, Singapore, and Zurich.
- C) London, Frankfurt, and Paris.
- D) London, Tokyo, and Zurich.

Answer: A

Topic: Foreign Exchange Market Locations

Skill: Recognition

22) The four currencies that constitute about 80% of all foreign exchange trading are

- A) U.K. pound, Chinese yuan, euro, and Japanese yen.
- B) U.S. dollar, euro, Chinese yuan, and U.K. pound.
- C) U.S. dollar, Japanese yen, euro, and U.K. pound.
- D) U.S. dollar, U.K. pound, yen, and Chinese yuan.

Answer: C

Topic: Foreign Exchange Market Currencies

Skill: Recognition

23) A _____ transaction in the foreign exchange market requires an almost immediate delivery of foreign exchange.

- A) spot
- B) forward
- C) futures
- D) none of the above

Answer: A

Topic: Foreign Exchange Market Transactions

Skill: Recognition

24) A _____ transaction in the foreign exchange market requires delivery of foreign exchange at some future date.

- A) spot
- B) forward
- C) swap
- D) currency

Answer: B

Topic: Foreign Exchange Market Transactions

Skill: Recognition

25) A spot transaction in the interbank market for foreign exchange would typically involve a two-day delay in the actual delivery of the currencies, while such a transaction between a bank and its commercial customer would not necessarily involve a two-day wait.

Answer: TRUE

Topic: Foreign Exchange Market Spot Transactions

Skill: Recognition

26) A forward contract to deliver British pounds for U.S. dollars could be described either as _____ or _____.

- A) buying dollars forward; buying pounds forward
- B) selling pounds forward; selling dollars forward
- C) selling pounds forward; buying dollars forward
- D) selling dollars forward; buying pounds forward

Answer: C

Topic: Foreign Exchange Market Forward Transactions

Skill: Recognition

27) A common type of swap transaction in the foreign exchange market is the _____ where the dealer buys the currency in the spot market and sells the same amount back to the same bank in the forward market.

- A) "forward against spot"
- B) "forspot"
- C) "repurchase agreement"
- D) "spot against forward"

Answer: D

Topic: Foreign Exchange Market Swaps

Skill: Recognition

28) Swap and forward transactions account for an insignificant portion of the foreign exchange market.

Answer: FALSE

Topic: Foreign Exchange Market Swaps

Skill: Recognition

29) The _____ is a derivative forward contract that was created in the 1990s. It has the same characteristics and documentation requirements as traditional forward contracts except that they are only settled in U.S. dollars and the foreign currency involved in the transaction is not delivered.

- A) nondeliverable forward
- B) dollar only forward
- C) virtual forward
- D) internet forward

Answer: A

Topic: Foreign Exchange Market Derivatives

Skill: Recognition

30) Which of the following is NOT true regarding nondeliverable forward (NDF) contracts?

- A) NDFs are used primarily for emerging market currencies.
- B) Pricing of NDFs reflects basic interest rate differentials plus an additional premium charged for dollar settlement.
- C) NDFs can only be traded by central banks.
- D) All of the above are true.

Answer: C

Topic: Foreign Exchange Market NDFs

Skill: Conceptual

31) A foreign exchange _____ is the price of one currency expressed in terms of another currency. A foreign exchange _____ is a willingness to buy or sell at the announced rate.

- A) quote; rate
- B) quote; quote
- C) rate; quote
- D) rate; rate

Answer: C

Topic: Foreign Exchange Market Rates and Quotes

Skill: Recognition

32) Most foreign exchange transactions are through the U.S. dollar. If the transaction is expressed as the foreign currency per dollar this known as _____ whereas _____ are expressed as dollars per foreign unit.

- A) European terms; indirect
- B) American terms; direct
- C) American terms; European terms
- D) European terms; American terms

Answer: D

Topic: Foreign Exchange Market Terms

Skill: Recognition

33) The following is an example of an American term foreign exchange quote:

- A) \$20/£.
- B) 0.85 euro/\$.
- C) 100¥/euro.
- D) None of the above.

Answer: A

Topic: Foreign Exchange Market Terms

Skill: Recognition

34) The European and American terms for foreign currency exchange are square roots of one another.

Answer: FALSE

Topic: Foreign Exchange Market Terms

Skill: Recognition

35) With several exceptions, most interbank quotes are stated in European terms (meaning foreign currency unit per U.S. dollar).

Answer: TRUE

Topic: Foreign Exchange Market Terms

Skill: Recognition

36) American and British meanings differ for the word billion. Therefore, when traders refer to an American billion, they call it a/an _____.

- A) Kiwi
- B) Loony
- C) Uncle Sam
- D) Yard

Answer: D

Topic: Billion

Skill: Recognition

37) Major exceptions to using European terms in foreign exchange include

- A) trading yen and euros.
- B) pounds and euros.
- C) Mexican Pesos and euros.
- D) all of the above.

Answer: B

Topic: Foreign Exchange Terms

Skill: Recognition

38) From the viewpoint of a British investor, which of the following would be a direct quote in the foreign exchange market?

- A) SF2.40/£
- B) \$1.50/£
- C) £0.55/euro
- D) \$0.90/euro

Answer: C

Topic: Direct Quote

Skill: Recognition

39) A/an _____ quote in the United States would be foreign units per dollar, while a/an _____ quote would be in dollars per foreign currency unit.

- A) direct; direct
- B) direct; indirect
- C) indirect; indirect
- D) indirect; direct

Answer: D

Topic: Direct and Indirect Quotes

Skill: Recognition

40) If the direct quote for a U.S. investor for British pounds is \$1.43/£, then the indirect quote for the U.S. investor would be _____ and the direct quote for the British investor would be _____.

- A) £0.699/\$; £0.699/\$
- B) \$0.699/£; £0.699/\$
- C) £1.43/£; £0.699/\$
- D) £0.699/\$; \$1.43/£

Answer: A

Topic: Direct Quote

Skill: Analytical

41) _____ make money on currency exchanges by the difference between the _____ price, or the price they offer to pay, and the _____ price, or the price at which they offer to sell the currency.

- A) Dealers; ask; bid
- B) Dealers; bid; ask
- C) Brokers; ask; bid
- D) Brokers; bid; ask

Answer: B

Topic: Dealers

Skill: Recognition

TABLE 6.1

Use the table to answer following question(s).

	Yen: Spot and Forward ¥/\$)			Pound: Spot and Forward (\$/£)		
	Mid Rates	Bid	Ask	Mid Rates	Bid	Ask
Spot	129.87	129.82	129.92	1.4484	1.4481	1.4487
Forward Rates						
1 month	129.68	-20	-18	1.4459	-26	-24
6 months	128.53	-136	-132	1.4327	-160	-154
Swaps						
2 year	117.65	1232	1212	1.4250	-238	-230
3 year	115.50	1452	1422	1.4225	-265	-253

42) Refer to Table 6.1. The current spot rate of dollars per pound as quoted in a newspaper is _____ or _____.

- A) £1.4484/\$; \$0.6904/£
- B) \$1.4481/£; £0.6906/\$
- C) \$1.4484/£; £0.6904/\$
- D) £1.4487/\$; \$0.6903/£

Answer: C

Topic: Spot Rate Calculation

Skill: Analytical

43) Refer to Table 6.1. The one-month forward bid price for dollars as denominated in Japanese yen is _____.

- A) -¥20
- B) -¥18
- C) ¥129.74/\$
- D) ¥129.62/\$

Answer: D

Topic: Forward Rate

Skill: Analytical

44) Refer to Table 6.1. The ask price for the two-year swap for a British pound is _____.

- A) \$1.4250/£
- B) \$1.4257/£
- C) -\$230
- D) -\$238

Answer: B

Topic: Swap Rates

Skill: Analytical

45) Refer to Table 6.1. According to the information provided in the table, the 6-month yen is selling at a forward _____ of approximately _____ per annum. (Use the mid rates to make your calculations.)

- A) discount; 2.09%
- B) discount; 2.06%
- C) premium; 2.09%
- D) premium; 2.06%

Answer: C

Topic: Forward Premium Calculation

Skill: Analytical

46) Refer to Table 6.1. Cross rates

- A) are often reported in the form of a matrix in the financial newspapers.
- B) can be used to check on opportunities for intermarket arbitrage.
- C) for the spot market in the table are $^5188.10/^\beta$ (using the mid rates).
- D) are all of the above.

Answer: D

Topic: Cross Rates

Skill: Recognition

47) Given the following exchange rates, which of the multiple-choice choices represents a potentially profitable intermarket arbitrage opportunity?

¥129.87/\$

euro 1.1226/\$

euro 0.00864/¥

- A) ¥115.69/euro
- B) ¥114.96/euro
- C) \$0.8908/euro
- D) \$0.0077/¥

Answer: B

Topic: Currency Arbitrage

Skill: Analytical

48) For arbitrage opportunities to be practical,

- A) participants must have instant access to quotes.
- B) participants must have instant access to executions.
- C) bank traders must be able to execute the arbitrage trades without an initial sum of money relying on their bank's credit standing.
- D) all of the above must be true.

Answer: D

Topic: Currency Arbitrage

Skill: Conceptual

49) The U.S. dollar suddenly changes in value against the euro moving from an exchange rate of \$0.8909/euro to \$0.08709/euro. Thus, the dollar has _____ by _____.

- A) appreciated; 2.30%
- B) depreciated; 2.30%
- C) appreciated; 2.24%
- D) depreciated; 2.24%

Answer: A

Topic: Foreign Exchange

Skill: Analytical

50) When the cross rate for currencies offered by two banks differs from the exchange rate offered by a third bank, a triangular arbitrage opportunity exists.

Answer: TRUE

Topic: Triangular Arbitrage

Skill: Recognition

51) Most transactions in the interbank foreign exchange trading are primarily conducted via telecommunication techniques and little is conducted face-to-face.

Answer: TRUE

Topic: Interbank Foreign Exchange

Skill: Recognition

52) Global daily foreign exchange turnover (combined swaps, spot, and forward transactions) has declined from roughly \$1,500 billion in 2001, to \$1,200 in 2004, to \$1,000 in 2007.

Answer: FALSE

Topic: Daily Foreign Exchange

Skill: Recognition

53) Given the following pair wise exchange rates, estimate the cross-rate of pounds per euro.

\$0.8410/£ \$1.2223/euro

- A) £1.000/euro
- B) £1.5062/euro
- C) £0.6639/euro
- D) euro 1.5062/£

Answer: C

Topic: Cross Rates

Skill: Analytical

54) Given the following quotations (where the dollar is the home currency), what is the annualized forward premium (discount) on the U.S. dollar?

Spot rate: \$1.305/euro 6-month forward rate: \$1.335/euro

- A) premium; 4.4944%
- B) premium; 4.5977%
- C) discount; 4.4944%
- D) discount; 4.5977%

Answer: D

Topic: Cross Rates

Skill: Analytical

55) The article in the text about an intern's first day on the job as a currency trader relates how what he/she had learned in business school had very little to do with how trading decisions were made on the floor of the exchange.

Answer: TRUE

Topic: Foreign Exchange

Skill: Recognition

56) The Continuous Linked Settlement system (CLS) links with the Real-Time Gross Settlement (RTGS) systems and is expected to eventually result in same-day settlement rather than the current two-day settlement required for foreign exchange spot market transactions.

Answer: TRUE

Topic: Foreign Exchange

Skill: Recognition

57) Currency trading increased tremendously between 2004 and 2007 with daily trading volume jumping from \$1.9 trillion to \$3.2 trillion. Which of the following do experts think was a major driving force behind the increased daily volume?

A) increased activity by specialized investment groups such as hedge funds

B) institutional investors holding more internationally diversified portfolios thus requiring more currency transactions

C) increased use of technical computer-based trading

D) all of the above

Answer: D

Topic: Foreign Exchange

Skill: Recognition

58) New York City has the greatest volume of foreign exchange activity in the world.

Answer: FALSE

Topic: Foreign Exchange

Skill: Recognition

5.2 Essay Questions

1) What are some of the reasons central banks and treasuries enter the foreign exchange markets, and in what important ways are they different from other foreign exchange participants?

Answer: Central banks and treasuries enter the foreign exchange market to acquire/spend their own foreign exchange reserves and to influence the price at which their own currency is traded. Unlike other market participants, they are not profit oriented. Instead, they may willingly take a loss if they think it is in their best national interest.

- 2) Define spot, forward, and swap transactions in the foreign exchange market and give an example of how each could be used.

Answer: Spot transactions are exchanging one currency for another right now. Spot transactions are typically entered into because the parties need to exchange foreign currencies that they have received into their domestic currency, or because they have an obligation that requires them to obtain foreign currency.

Forward foreign exchange transactions are agreements entered into today to exchange currencies at a particular price at some point in the future. Forwards may be speculative or a hedge against unexpected changes in the price of the other currency.

Swaps are the simultaneous purchase and sale of a given amount of a foreign exchange for two different dates. Both transactions are conducted with the same counterparty. A swap may be considered a technique for borrowing another currency on a fully collateralized basis.